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# Understanding Global Imbalances

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**Abstract**

Although there have been surplus and deficit nations in the world for some decades, the 2008 global financial crisis underscored the magnitude of the so-called global imbalances which provided the macroeconomic backdrop to the worst financial crisis in nearly a century. The two key players are the United States and China, which have been the twin major engines of growth in the world economy since the 1980s. But, the changed global economic structure involves many more nations, specifically the rise of emerging economies in the early 1990s. The global economy fundamentally changed then with the take-off of the "open door" policy in China in 1992, the switch to export-oriented from import-substitution policies in India after its 1991 balance of payments crisis, and the re-joining of Eastern Europe after the fall of Communism in the former Soviet bloc at the start of the 1990s. These nations together doubled the global labour force to three billion people, which effectively halved the capital-to-labour ratio in the world. This led to falling wages and therefore lower prices, including the cost of imports into rich economies. The deflationary effect, particularly of China with its 700 million labourers, meant that inflation was low throughout the 2000s whilst growth was strong and thus allowed interest rates to stay low in the West. Capital was cheap both in terms of price and also in returns given the additional labour in the global economy. Rapid growth and plentiful liquidity led to consumption via borrowing in the U.S., while export-oriented economies accumulated ever-increasing amounts of foreign exchange reserves. The consequence of which was a flattening of the U.S. bond yield curve since there was a growing demand for dollar-denominated assets by emerging economies in developing Asia and amongst Middle Eastern oil exporters to maintain stable exchange rates while their current account surpluses grew. The other side of the deflationary effect of China and other surplus economy was upward pressure on commodities, generating a supply side boom that peaked in the summer of 2008. The rise in energy prices furthered fuelled the accumulation of reserves in the Middle East throughout the 2000s.

In 2001, after the bursting of the U.S. dot.com bubble, loose monetary policy in the United States fuelled a further asset bubble in sub-prime mortgages. With inflation targeting in place, the low inflation rate did not flag the need for higher interest rates even though there was excess liquidity in the economy chasing yields. When interest rates started to rise in 2004, the downward pressure on the yield curve kept both long- and short-term interest rates low which fuelled the housing bubble until it burst in the summer of 2007. Global imbalances, therefore, provided the context to the current crisis. Although longstanding, the shift to independent central banks and the trend of financial de-regulation since the late 1980s coincided with a changed global economy. This paper seeks to understand the interactions of the U.S. and China throughout this period within the larger context of the global economic crisis. Using a gravity model, the respective weights exerted by the U.S. and China will be investigated to shed light on the pull and push factors of the global macroeconomic identities of current account surpluses/deficits, global net savings, and the drivers of foreign exchange accumulation. By understanding better the drivers of the


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global imbalances, recommendations can be put forward to assist in the process of re-balancing and recovery from this historical financial and economic crisis.


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## 1. The Changed Global Economy of the 1990s

Although there have been surplus and deficit nations in the world for some decades, the 2008 global financial crisis underscored the magnitude of the so-called global imbalances which provided the macroeconomic backdrop to the worst financial crisis in nearly a century. The two key players are the United States and China, which have been the twin major engines of growth in the world economy since the 1980s. But, the changed global economic structure involves many more nations, specifically the rise of emerging economies in the early 1990s. The global economy fundamentally changed then with the take-off of the "open door" policy in China in 1992, the switch to export-oriented from import-substitution policies in India after its 1991 balance of payments crisis, and the re-joining of Eastern Europe after the fall of Communism in the former Soviet bloc at the start of the 1990s. These nations together doubled the global labour force to three billion people, which effectively halved the capital-to-labour ratio in the world. This led to falling wages and therefore lower prices, including the cost of imports into rich economies. The deflationary effect, particularly of China with its 700 million labourers, meant that inflation was low throughout the 2000s whilst growth was strong and thus allowed interest rates to stay low in the West. Capital was cheap both in terms of price and also in returns given the additional labour in the global economy. Rapid growth and plentiful liquidity led to consumption via borrowing in the U.S., while export-oriented economies accumulated ever-increasing amounts of foreign exchange reserves. The consequence of which was a flattening of the U.S. bond yield curve since there was a growing demand for dollar-denominated assets by emerging economies in developing Asia and amongst Middle Eastern oil exporters to maintain stable exchange rates while their current account surpluses grew. The other side of the deflationary effect of China and other surplus economy was upward pressure on commodities, generating a supply side boom that peaked in the summer of 2008. The rise in energy prices furthered fuelled the accumulation of reserves in the Middle East throughout the 2000s. Until the onset of the 2008 global financial crisis, this period had been called the 'nice decade' or the 'Great Moderation' since it marked an era of strong growth, low inflation, and therefore low interest rates.

## 2. Independent Central Banks & Financial Deregulation

The changes in the global economy coincided with the early 1990s movement to create independent central banks (starting in New Zealand in 1991 and was undertaken by the UK and European Central Bank or ECB in the late 1990s) which has also been credited with increasing transparency about monetary policy. However, targeting asset bubbles was not part of such mandates, and this became an evident problem during the 'Great Recession' which followed the near-collapse of the banking system in the West. It wasn't only monetary policy which changed. Financial de-regulation since the 1980s also led to financial innovation that had led to the abandonment of the previous targeting of monetary aggregates (e.g., M2) by Western central banks. Because of the growth of financial intermediation and globalised nature of liberalised financial markets, the monetary transmission mechanism did not operate to simply transform the central bank's monetary target into the economy. Thus, central banks moved from controlling the supply of money to its price (or interest rates) in order to manage inflation and the business cycle. De-regulation also led to financial instruments and global linkages became much more diverse, leading to securitisation of assets which were sold and bought around the world. In 1999, the U.S. Gramm-Leach-Bliley Act repealed the Glass-Steagall of 1933 that had previously separated retail from investment banking operations. This notably transmitted the risks undertaken by investment banks to retail banks which led to the possibility of systemic banking system failure in the 2008 financial crisis that is reminiscent of the 1930s banking crisis that had led to the passage of Glass-Steagall in the first place. Around that time, European banks were also able to access U.S. wholesale money markets to a greater extent so their lending became less reliant on deposits and also meant that they could access the same cheap money as the Americans even though the European position is not a significant contributor to the global imbalances. The balance of payments and savings rate of Europe have not changed dramatically in the past decade; yet, the losses at European banks due to non-performing assets have been worse than in American ones.

## 3. Genesis of a Crisis

In 2001, after the bursting of the U.S. dot.com bubble, loose monetary policy in the United States fuelled a further asset bubble in sub-prime mortgages. Although this is the usual utilisation of monetary policy (cutting interest rates during a recession to stimulate the economy), the question is why did interest rates stay so low for so long that contributed to a further bubble in housing? With the focus on inflation and maintaining price stability, the Federal Reserve did not act to raise interest rates because inflation was low. This is in spite of growth being strong and excess liquidity in the economy which led to mis-priced risk that was at the heart of the financial crisis. Because the cost of borrowing was so low, lenders sought borrowers even if they were sub-prime ones. When interest rates started to rise in 2004, the downward pressure on the yield curve kept both long- and short-term interest rates low which fuelled the housing bubble until it burst in the summer of 2007. Another view of the global imbalances picture is to consider the falling U.S. saving rate. Savings as a share of disposable income fell to less than 1% on the eve of the crisis. With a low supply of saving, the cost of borrowing should have risen, but did not because the United States could access global savings due to its position as the *de facto* global reserve currency. Demand for dollar-denominated debt was driven not just by the U.S. current and capital accounts or balance of payments, but also by commodity trades priced in dollars, international investments and as a hedging instrument since the dollar is considered to be a "safe haven." The increased purchases of central banks amassing reserves totalling several trillion in the 2000s, largely in dollars, depressed long-term rates as well as the short-term ones controlled by the Fed. Low interest rates further deterred saving and led instead to a search for yields as housing offered greater returns than the negative real interest rates for cash.

## 4. Global Imbalances

Global imbalances, therefore, provided the context to the current crisis. Although long-standing, the shift to independent central banks and the trend of financial de-regulation since the late 1980s coincided with a changed global economy. By understanding better the drivers of the global imbalances, recommendations can be put forward to assist in the process of re-balancing and recovery from this historical financial and economic crisis.

The key facts are:

The U.S. has run a current account deficit for some time, but it clearly worsened to reach 6% of GDP or 1.7% of global GDP. Its mirror is in the surpluses of emerging Asia and Middle East oil exporters which have also increased significantly during the past decade, even though they have been surplus economies for some time. For instance, China had only a modest balance of payments surplus until around 2005 (Figure 1).

The imbalances are mirrored in the savings picture, where U.S. savings have fallen in the past decade whilst Chinese and Asian savings rose (Figure 2). The European countries in both figures have not changed their external or domestic positions much during this period.

The increase in foreign exchange reserves in Asia and amongst Middle East oil exporters is evident since the early 2000s (Figure 3).

## 5. Conclusion

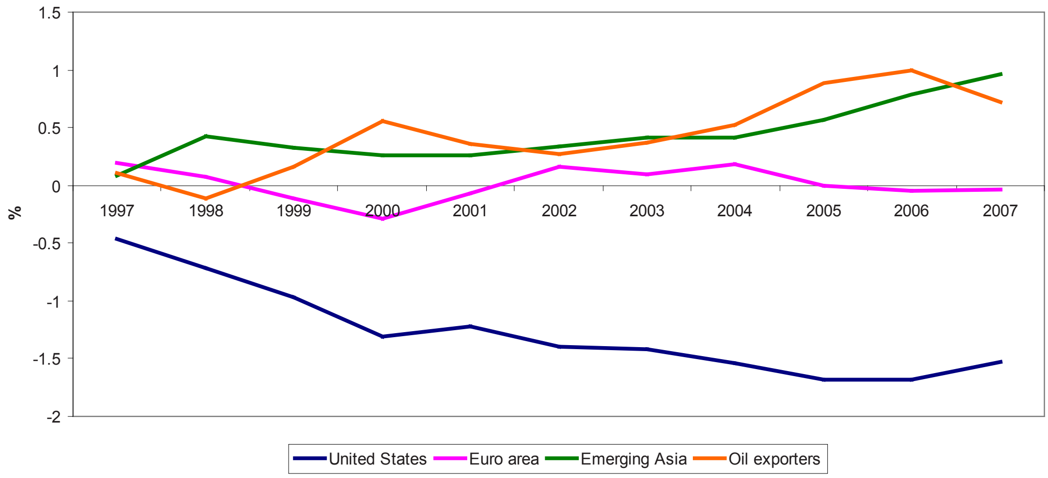
The macroeconomic context to this global financial crisis points to the importance of global imbalances and re-balancing as a part of recovery. Since the 1990s, there has been an increase in the global labour supply, leading to falls in prices of traded goods and services. This in turn generates low interest rates in Western economies as inflation stays low despite strong growth due to cheaper imports. Also, there has been a fall in the global capital to labour ratio, which increases returns to capital while makes it all the more attractive to seek yields whilst the cost of capital is cheap. Global imbalances are part of this picture of excess liquidity which has fuelled cheap credit and leverage or borrowing in the West. In emerging economies like China, capital controls and trapped savings limited capital account outflows that adds to their balance of payments surplus which in turn leads to accumulation of reserves which increases purchases of dollar-denominated assets and fuels more lending. Ironically, the crisis has led to a credit crunch in the West, but China may well experience the “hot money” inflows which will lead to asset bubbles in its real estate and stock markets. Finally, the fixed exchange rate regimes of emerging economies also depressed bond yields such that U.S. monetary policy was too accommodative for too long which contributed to the bursting of the U.S. housing bubble.

## 6. Recommendations for Global Re-balancing

There is already re-balancing in the global economy due to the U.S. de-leveraging. For instance, the U.S. current account deficit is at its lowest point in a decade (under 3% of GDP), and the U.S. savings rate has risen some four-fold. For China, the collapse of exports has been offset by a dramatic decline in imports, so that it may well still run a current account surplus despite massive closures of export industries during the global recession. As a result, China is experiencing significant inflows of capital which, along with its own loose monetary policy to combat the recession, is contributing to potential asset bubbles in its real estate and stock markets. By implementing its “going out” policy, China should experience more capital outflows that will reduce its balance of payments surplus and foreign exchange holdings, which will have the further effect of easing liquidity in its economy. It is also a more effective way of re-allocating saving from East to West through foreign direct investment and equity investment rather than via government bonds. In that way, Asian savings can be utilised in the West, which will help with re-balancing and also alleviate the bankruptcies due to the credit crunch.

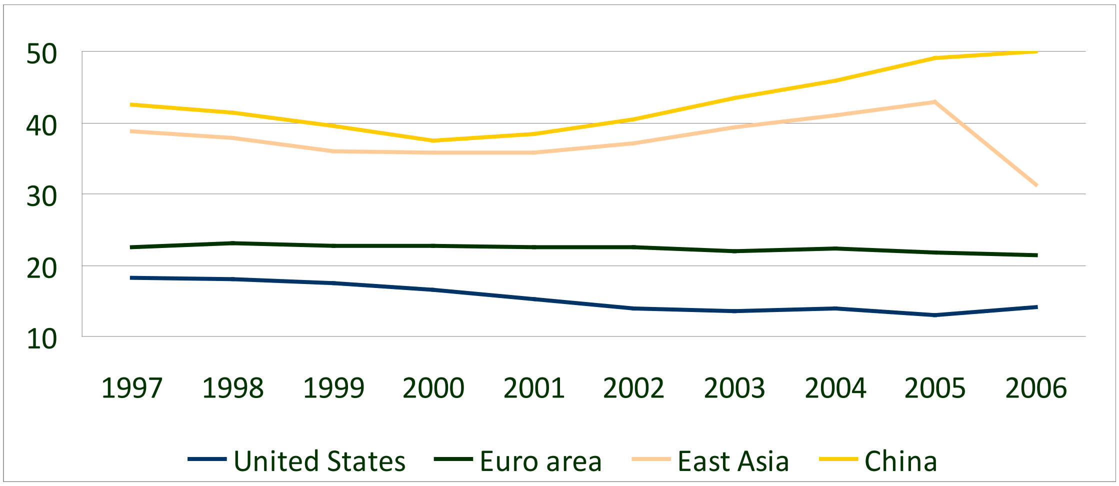
Capital account liberalisation and greater exchange rate flexibility in China will ease the global imbalances. De-leveraging and increased savings in the United States will accomplish the same on the other side of the equation. As a developing country, China is likely to continue as a net exporter while the U.S., as a rich economy, will continue to be a net importer, particularly with the dollar as the global reserve currency that implies an external deficit. Although neither country is likely to completely re-balance the global economy, the reining back of the excesses of the past decade to take into account the fundamentally altered nature of the macroeconomic context of the 2000s will pave the way for a more stable period of economic growth.

Figure 1 Current account balances, % of world GDP



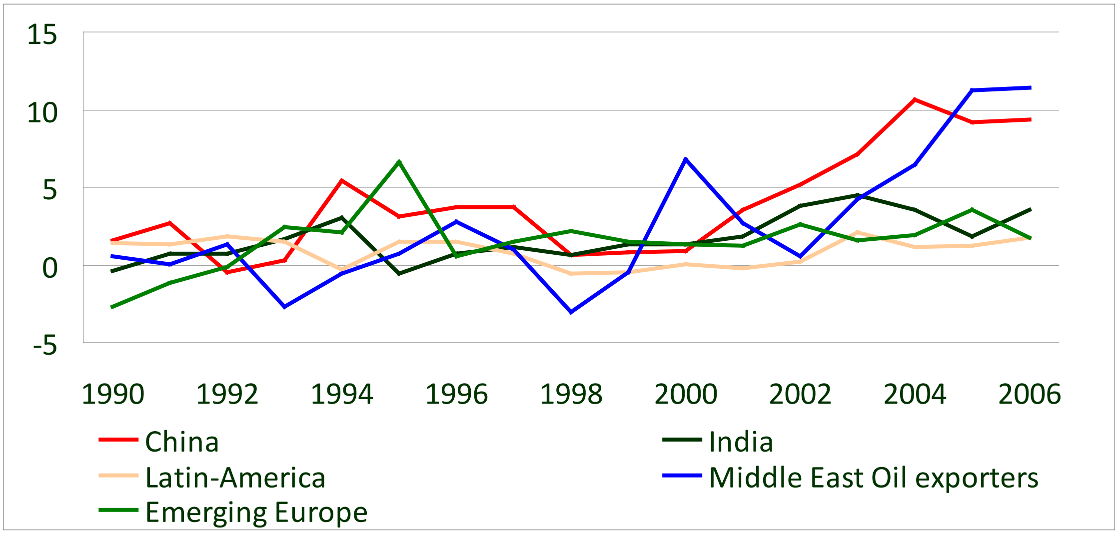

Source: World Development Indicators, World Bank.

Figure 2 Gross domestic savings, % of GDP




Source: World Development Indicators, World Bank.

Figure 3 Foreign exchange reserves, % of GDP




Source: World Development Indicators, World Bank.